MULTICHANNEL MERCHANT

OPERATIONS SPECIAL REPORT

MCM Outlook 2016

THE AMAZON EFFECT CONTINUES TO DRIVE CHANGE ECOMMERCE OPERATIONS

The effect of Amazon on the direct-to-customer and ecommerce landscape, and the changing customer expectations it has helped to engender, continue to be a major factor as seen in the ripples throughout the world of operations and fulfillment, judging by the results of the MCM Outlook Survey 2016.

This impact is being felt in the many ways merchants are fighting back against the Seattle juggernaut, from the increasing frequency of same-day and next-day delivery offerings – and providers – to the growth in omnichannel operations, now seen as table stakes by many retailers.

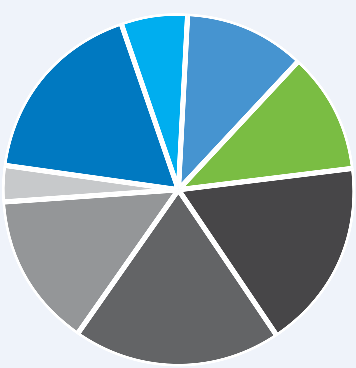
While competition comes from many sources, the growing dominance of Amazon in every aspect of ecommerce is evident. Consider the fact that it is now pushing into its own delivery and logistics operations, including leasing

CONTINUED ON PAGE 2

What was your cutoff date for holiday deliveries?

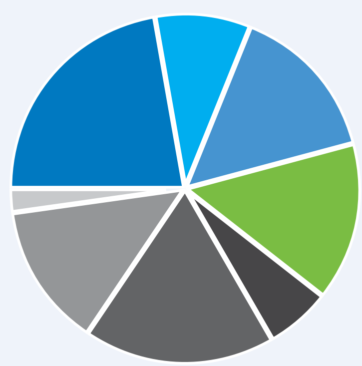
- **Dec. 17:** 17.5%
- **Dec. 18:** 6.3%
- **Dec. 19:** 11.1%
- **Dec. 20:** 11.1%
- **Dec. 21:** 17.5%
- **Dec. 22:** 19.0%
- **Dec. 23:** 14.3%
- **Dec. 24:** 3.2%

2015

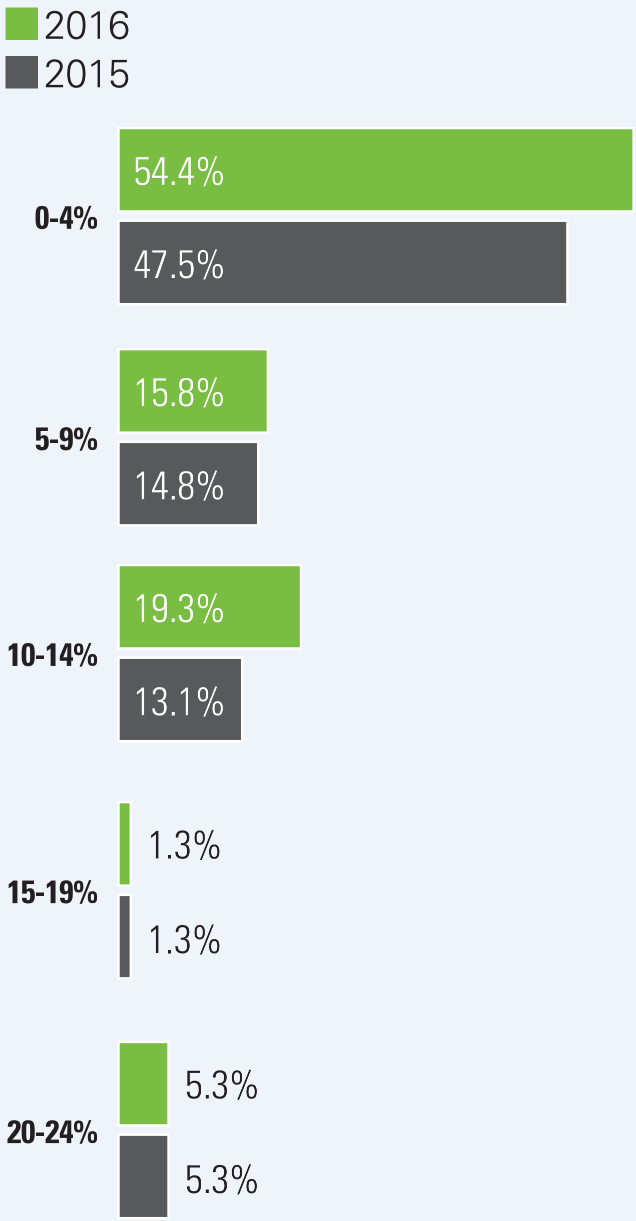


- **Dec. 17:** 22.1%
- **Dec. 18:** 8.8%
- **Dec. 19:** 14.7%
- **Dec. 20:** 14.7%
- **Dec. 21:** 5.9%
- **Dec. 22:** 17.6%
- **Dec. 23:** 13.2%
- **Dec. 24:** 2.2%

2014



What percentage of your orders is shipped outside the U.S.?



cargo jets in the U.S. and getting involved in ocean-going freight from Asia, and it becomes clear that Amazon wants to own both sides of the ecommerce equation.

In the 2016 MCM Outlook Survey, respondents told us about the impact Amazon was having on their business. The largest number of respondents, 45.3%, said it was causing pressure on them to ship faster – a reaction to Amazon Prime's two-day delivery guarantee, as well as Prime Now same-day services in many metro areas. Almost as many of those polled (43.8%) said they felt pressure to offer free shipping, while 31.2% said it led them to be more price competitive, and 17.2% said it caused them to sell their products in online marketplaces.

For Tobi.com, a pure-play seller of women's fashion, part of the response to Amazon has been using the U.S. Postal Service's Priority Mail and Priority Mail Express offerings. The company's clientele has been very happy with an average delivery rate of 2.7 to 3 days throughout the U.S., said Mark Stoye, Tobi.com's director of ecommerce fulfillment operations, and free Saturday delivery is big a plus. At present, Stoye said, same-day delivery is not a priority for his customers.

Like many other companies, Victorian Trading Co., an online and catalog seller of Victorian era clothing and gifts, doesn't see the point of competing with Amazon's vast resources and ability to operate in the red for quarters in a row. Ian Richardson, the company's Manager of IT and Order Operations, said its Midwest distribution center enables guaranteed four-day delivery to 98% of the U.S. via USPS-enabled FedEx SmartPost and UPS SurePost, which is good enough for his clients. He added Victorian Trading does sell on Amazon as well as a hedge.

The growth of omnichannel

The 2016 Outlook Survey gave clear indication of the growth of omnichannel operations among retailers. Of those companies with stores, 27.8% said they offer ship to store, up from 10.6% in 2015, while 41.7% said they provide ship from store, a big jump from 13.6% in the prior year. The practice of buy online pickup in store – an option that retailers love for its economy – just about doubled among MCM's audience, from 21.2% in 2015 to 44.4%. Web-enabled kiosks were an option offered by 16.7% of survey respondents with stores, up from 4.5% in 2015. But the biggest increase was in those saying they offered in-store return or exchange of online purchases, from 18.2% to 61.1%. This last option is increasingly seen as a required option for shoppers, even though it can be tricky in terms of assigning credit between store and ecommerce operations.

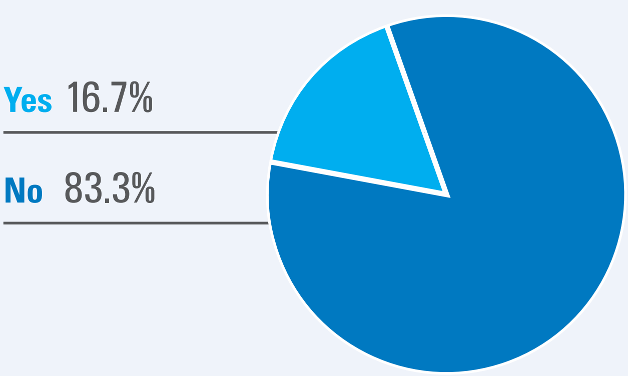
While omnichannel has become an imperative in retail, many companies are still struggling to figure out how to make it work profitably. There have been a number of recent reports detailing the cost of omnichannel fulfillment. For instance, EKN Research and Aptos Inc. found that satisfying shoppers' omnichannel expectations accounts for 18% of every sale, while another study from PwC detailed how only 19% of executives think omnichannel order fulfillment strategies improve company profitability.

The contrast in recent financial results from The Finish Line and Target give a good picture of how this is playing out. The sporting goods retailer had a brutal fourth quarter of 2015, in large part due to the failure of a new warehouse management and order management system. System issues led to difficulty filling online orders and replenishing stores, resulting in $32 million in lost sales, about 8% of revenue for the period, and the resignation of its CEO.

Target on the other hand had a fantastic Q4 2015, much of it due to its terrific omnichannel execution. The company reported a 34% increase in digital sales in the fourth quarter, well ahead of Walmart (8% growth) and online sales in general as well as Amazon (both 15% growth). Thirty percent of the quarter's digital sales came from either ship-from-store or buy online, pickup in store transactions.

One of the biggest challenges for retailers in omnichannel is figuring out the operational and financial implications of exposing all their inventory – store and ecommerce – to every consumer touchpoint and making it available to purchase, knowing not every store or even the nearest ecommerce DC can carry everything.

Do you plan to offer same-day delivery in 2016?



If a woman shops online and finds four apparel items she wants, three of which are in three different stores and one in an ecommerce DC, what does that mean in terms of fulfillment, cost and customer satisfaction? In that scenario, you have to ship four items separately and incur that cost against whatever shipping offer you've made. Or do you keep stock levels higher to avoid that fulfillment nightmare, but then risk languishing inventory, added costs and markdowns? It's a continual balance between customer need and cost, selling through product at the highest margin while meeting omnichannel's increasingly anywhere/anyhow/anytime demands.

Third-party fulfillment

Among respondents to the MCM Outlook Survey, the use of third-party fulfillment (3PL) partners to outsource their operational functions is growing slightly but still represents by far a minority approach. In 2016, 26.5% of respondents said they use a 3PL, up from 21.2% in 2015, while the rest said they handle fulfillment internally. Of those who said no, only 2.9% are considering use of a 3PL, down from 6.2% in 2015.

Tobi.com's Stoye said his company was not using or considering a 3PL at this point. The company has developed its own efficient and cost-effective fulfillment system, and doesn't want to lose the "hands on" connection with customers, he said.

Similarly, Richardson of Victorian Trading Co. said a 3PL partner doesn't make sense for its fulfillment operation. The company ships around 300,000 packages a year, he said, almost entirely small parcels, and so has been able to get very competitive discounts.

That said, there are situations where outsourcing fulfillment operations to a 3PL can make good business sense. Curt Barry, president of F. Curtis Barry & Co., wrote recently about the decision process in considering a 3PL, and some of the areas where companies can see benefits:

Cost per order: A 3PL can provide a lower cost per order when compared to internally managed operations. This isn't always true but it can be for small- to moderate-sized companies that don't have four season businesses.

Focusing management time: A 3PL allows companies to concentrate management time on marketing, merchandising and ecommerce analysis. Some large companies understand fulfillment isn't their core competency, and thus a 3PL makes sense.

Scale to peak: During the holiday season, a 3PL allows companies to successfully process customer orders without hiring additional staff and requiring greater internal capacity.

Lower capital investment: A 3PL can help reduce capital outlays for things like new fulfillment facilities, order management and warehouse systems, telephone technology and in some cases website platforms.

Reduced time-to-customer and shipping costs: A 3PL can provide distribution across the country so that you can deliver one-day ground to a high percentage of your customers. Some 3PLs can deliver items within hours of receiving an order in certain cities.

Distribution of international orders: Many multichannel companies use 3PL partners to serve Canada, Europe and Asia.

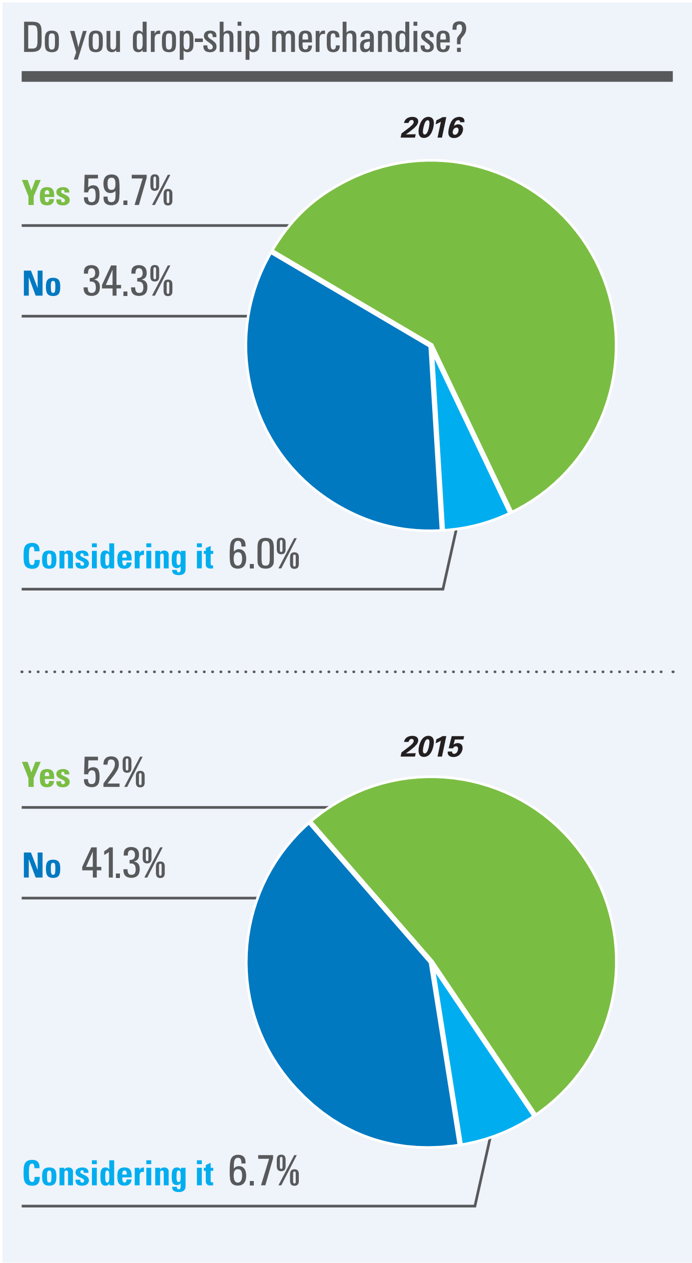
Direct shipping: Store-based retailers sometimes contract with 3PL partners to ship direct orders from their ecommerce marketplaces, rather than bring small-order pick/pack/ship into their DCs.

Ecommerce returns

As cited in the omnichannel scenario above, the growth in ecommerce sales has brought with it a commensurate increase in the rate of returns, as online shoppers are more apt to buy multiple items and keep only what they want, or find what they ordered wasn't what they expected. According to a recent study from Shorr Packaging, online sales typically represent 6.7% of total retail sales, but ecommerce returns rates were projected to top 30% during the 2015 holiday season.

A higher percentage of retailers adopting more liberal returns policies to help drive sales, along with the general rise in ecommerce transactions, drove a significant increase in returns during the holiday season 2015, according to ecommerce fulfillment provider Newgistics. Patrick Allard, the company's vice president of business development, said among the 450 retailers and brands the company works with, there was an increase in returns volume between 18% and 35% in January and into February. However, Allard and others noted, providing a "frictionless" return policy, often at no charge, is a terrific sales lever.

In the 2016 MCM Outlook Survey, just over a quarter of respondents – 26.2% – said 1% or less of their ecommerce orders are returned, down from 43.1% in 2015. The number of those saying their ecommerce return rate was 2% also decreased, from 13.9% to 10.8%. But there was an increase in those who reported return rates in the 3%-4% range, from 16.7% to 20%, and in those saying it was 10% to 14% (from 8.3% to 15.4%). So clearly the trend is upward for higher ecommerce



return rates, and downward for lower return rates.

There are ways to combat this increase and keep ecommerce return rates in check. According to a recent study by researchers at the University of Texas-Dallas, retailers can reduce their return rate by limiting the scope of what is eligible (i.e. by disallowing sale items) and by giving customers a longer return period. While this second point may seem counterintuitive, the researchers found that the longer a customer has an item in hand, the greater the likelihood of attachment and the lesser the likelihood of a return. And while limiting the scope of eligibility can reduce returns, it can also run the risk of impacting sales.

Lauri Sullivan, Chief Financial Officer and Chief Operating Officer for Donna Salyer's Fabulous Furs, said her company has been able to reduce its ecommerce return rate from 22% four years ago to 16% today by taking several steps:

- **Providing consistency in size charts between catalogue and online**
- **Improving vendor specification requirements**
- **Purchasing merchandising software for consistent product specs**
- **Continually adding notes in the ERP system about product fit for customer service agents**
- **Improved, consistent training for all call center employees**
- **Increasing the number of product photos, including all views**

Louis DeJianne, retail and consumer goods director for UPS, said it's important to keep in mind that ecommerce has shifted power to the consumer. Where in the past companies made it difficult for customers to return products, DeJianne said UPS research indicates that making returns easier builds brand loyalty. Savvy retailers, he said, are incorporating returns into sophisticated marketing and communications programs that result in ongoing customer engagement.

System purchase plans

The top system purchase needs in 2016, based on results from the MCM Outlook Survey, is warehouse automation. Of respondents, 13.1% said they planned to make an automation purchase in the next 12 months, more than twice the result from 2015 (5.3%). Several other types of system purchase were listed by 11.5% of respondents: warehouse management system (WMS), order management system (OMS), CRM, end-to-end ecommerce platforms, business intelligence and shipping/delivery systems.

Given the continued growth of ecommerce, creating shrinking order sizes yet higher order volume and high service levels, it's no surprise that more direct-to-customer and ecommerce companies are looking to implement automation solutions. Historically successful but rudimentary equipment and processes can reach the stress point in terms of space, systems, people and product.

For a growing number of companies, automated systems have become a way to address the issue of increased throughput, order accuracy and returns. In addition to accuracy, often the biggest driver of automation decisions, the ability to achieve higher throughput per headcount, increasing efficiency while keeping down labor costs, is -also paramount.